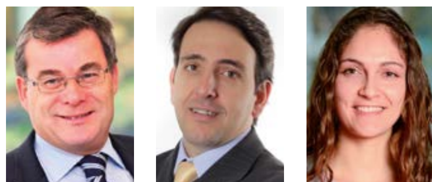
Special report
Tax and Brazil

The feature, prepared by Deloitte, is the second in the series of reports examining the tax landscape in BRIC countries. The report provides an overview of the tax landscape, an explanation of setting up a business, and details the key taxes.



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Why Brazil?

From FTSE 100 companies to SMEs, UK businesses are increasingly investing in Brazil.

Brazil is the fifth largest country in the world by area and by population and one of the most multicultural and ethnically diverse nations on the planet. Yet until relatively recently, Brazil was an economic back-marker by comparison with other major industrialised nations. That is no longer the case: it is now the world's sixth largest economy by GDP. Although growth slowed in 2012, most economists believe temporarily, the boom in the Brazilian economy has caught the attention of foreign governments and multinational companies alike. There is growing and sustained interest in Brazil, with many companies expanding their activities and realising growth in that market, further buoyed by the infrastructure developments required for the 2014 football World Cup and the 2016 Olympics.

> **With the notable exception of the energy and mining sectors, the UK has been quite late to the party**

With the notable exception of the energy and mining sectors, the UK has been quite late to the party. China, the US, Japan, Germany, France, Spain and Portugal have long recognised the opportunities of a country that has developed a huge economy, in which 40 million people have moved up into the middle class in the last five years, and with many self-made billionaires.

The UK's position is changing rapidly across all sectors and ranging from FTSE 100 companies to SMEs to high-tech start-ups, UK businesses are now investing in Brazil.

There is, however, at least one significant hurdle that has to be negotiated when investing in or trading with Brazil: taxation. Brazil has a complex tax system which contains numerous features that may be unfamiliar to many international tax practitioners. We hear from clients that the Brazilian tax system is difficult, bordering on the impossible, that it is very hard to extract money from Brazil and that the UK is hindered by the lack of a double tax treaty.

We say that Brazilian tax is not difficult; it is different. As with many aspects of Brazil, if one is prepared to embrace difference and to invest time to understand it, there is no reason why tax should be a barrier to successful investment in Brazil.

This report outlines the tax environment in Brazil and some of the key considerations when establishing a business in Brazil. We then provide an overview of corporate income tax, indirect taxes, import duties and withholding taxes, together with some thoughts on cross-border issues and finally some observations on structuring and financing a Brazilian acquisition.

The tax environment

Seeing the wood for the trees …

In what follows, we have set out summaries of some of the key taxes and rules that apply in Brazil. The fact that so many of these are unfamiliar in a non-Brazilian tax context is one of the main factors that gives rise to the general view that Brazilian taxation is highly complex, if not impenetrable. There are a number of key principles to bear in mind that can help in seeing the wood for the trees and producing a greater clarity of understanding:

- Brazil is a federal republic divided into 26 states and one federal district. Each state has a significant degree of autonomy in setting some of its own taxes and tax rates. Think USA, not UK.
- Interstate taxes can have a material bearing on the overall tax burden of a company with business in multiple Brazilian states. Domestic supply chain planning can be very important.
- The idea that UK business is disadvantaged by the absence of a double tax treaty with Brazil is a bit of a myth. From a corporate perspective, there are almost no advantages available to companies in treaty countries, at least without being prepared to embark on lengthy and costly litigation, because of the interpretation the Brazilian authorities take on certain treaty relief provisions.
- Bureaucracy is rife but compliance is very important. Obtaining import licences, registering loans at the Central Bank and so on, are generally straightforward, but extremely critical. Complying will enable you to get goods and money into and out of Brazil with ease; failing to comply will lead to an entirely different experience.
- Beware of local business partners telling you that costs and corners can be cut, for example through the use of 'despachantes' (customs brokers).
- Employing people in Brazil brings you straight into labour laws that involve significant administration and payroll costs – the net take-home pay of a Brazilian worker may often be less than half of the cost to the company of employing them.
- Dividends can be remitted abroad tax-free, although it is often more tax-efficient to elect for a deductible dividend, known as interest on net equity (INE), on which withholding tax does apply, but which is deductible against Brazilian profits.

- While the headline Brazilian corporate tax rate is relatively high at 34%, there are a number of ways to mitigate it. These include: INE; goodwill step-ups on acquisition; debt funding of up to a 2:1 debt-to-equity ratio; R&D tax credit reliefs; the availability in many states and municipalities of substantial tax incentives, typically in return for local investment and job creation; the availability of export credits; and employment tax and social security incentives in certain industries.
- The so-called 'deemed profit' regime can reduce the compliance burden and in some cases the overall tax burden for companies with Brazilian sales of less than R$48m (R$72m from 2014).
- There are many indirect taxes. The only one that widely applies to both goods and services is PIS/COFINS.
- Other indirect taxes are generally applicable either to goods or services, but not both. Some of these taxes apply in both domestic and cross-border situations; others apply only to the latter. Cross-border indirect taxes are not creditable by the foreign recipient.
- Most foreign remittances are additionally subject to a withholding tax of 15%. However, for profitable UK companies, this should amount to no more than a cashflow cost, as it is generally creditable against UK corporation tax.
- Take advice upfront, get your tax returns in on time and get them right. Outsource to professionals.
- The tax authorities are litigious and rarely engage face-to-face. Diligent compliance may not avoid tax assessments and penalties completely, but it will significantly reduce risk. Defending tax assessments is not only costly, but also takes up significant management time.

A federal, state and municipal tax system

Taxes are levied at the federal, state and municipal levels, comparable in some ways to the USA.

Corporate income taxes are of a federal nature only, but many indirect taxes are levied at the state and municipality level as well. Administratively, this results in multiple tax registrations with the relevant states and municipalities and multiple deadlines for filings, tax payments and reporting requirements.

Tax compliance therefore requires significant manpower and companies either employ large in-house tax departments or outsource the compliance function to professional services firms. The operation of different state and municipality indirect tax systems results in there being 'imports' and 'exports' between the states, affecting the applicable tax rates and the tax returns to be filed. This often results in an odd-looking supply chain, where a company takes maximum advantage of the indirect and import tax savings and incentives available in certain states.

The types of taxes that may be levied, and the tax treatment of individual items in tax returns, are established at the federal level, with authority in respect of interstate and intrastate rates being granted to the states and municipalities, with specified limits for maximum and minimum rates. However, there are frequently differences in the interpretation of tax treatment between states. This can sometimes result in different outcomes at state level, even if the rules governing a particular tax have been determined at a federal level.

Furthermore, state tax authority offices can issue their own guidance on the tax treatment of specific items which will differ from the guidance issued by offices in other states. In these cases, a request can be made by the taxpayer for a federal resolution to confirm the correct interpretation, but these are extremely rare.

> **The process for enacting tax legislation is very different from that in the UK**

Tax incentives

Federal law provides for states and municipalities to offer tax incentives in respect of certain taxes and within certain limits. These incentives are more prevalent in the north of Brazil, typically requiring investment in jobs and infrastructure. As a result, major multinationals have established substantial plants in these regions.

Legal system

The process for enacting tax legislation is very different from that in the UK. Advance consultation with taxpayers or professional bodies is rare. Changes in interpretation or specific tax rules can be brought into effect not only through law changes, but also through 'provisional measures' or 'normative rulings' which can come into force at short notice. Provisional measures are issued by the president, to deal with urgent matters, although in practice these are very common and must be approved by Congress to become law. Normative rulings provide instructions to tax inspectors and taxpayers on how to apply certain rules set out in the law, and often include new interpretations or detailed clarification. All can have effect immediately after official publication, or else come into effect at a specified date, usually the first day of the following calendar year.

Brazil has a Roman-Germanic civil law system, similar to that of continental Europe, based on codified statute and thus, unlike the common law system used in the UK, legal cases are *not* binding on other courts presiding over a later case, although they may be persuasive.

The exception to this is cases heard by the Supreme Court which may publish binding rules. This aspect is undoubtedly one reason for the reputation that the Brazilian tax system has for lacking clarity, and can be frustrating for foreign investors, who may struggle to get a clear opinion from advisers – this is not helped by the absence of any advance ruling system from the federal tax authorities.

Tax compliance landscape

Table 1 (overleaf) illustrates the complexity of tax compliance in Brazil. It details the returns required to be filed by the average company: these include not only tax returns but also disclosure returns for certain transactions, such as those with non-resident parties. This is not a comprehensive list; the actual filings required will depend inter alia on the nature of a company's activities.

Tax repayments

Where taxes have been overpaid or there is a net repayment position on indirect taxes, it is extremely difficult to obtain a

Table 1: Brazilian returns and filings

Filings and returns	Tax/filing obligation	Return period	Delivery deadline
IN86 (Normative Instruction 86)	Taxpayer obliged to maintain records in a specific electronic format	On request	On request by Brazilian Federal Revenue ('RFB')
MANAD	Digital payroll information	On request	On request by RFB
RAIS	Register of annual employee changes and remuneration	Annually	Annually imposed by Ministry of Labor/Social Security
SPED – accounting system nomenclature (accounting)	Accounting records	Annually	Last business day of June
SPED – Public accounting system nomenclature (tax)	Accounting records for tax	Monthly	5th of the following month
DIPJ and FCONT	Corporation tax returns	Annually	30 June of the following calendar tax year
DCTF	Declaration of federal taxes	Monthly	15th of the following month
DACON	Return for all social contributions, e.g. PIS/COFINS	Monthly	5th of the following month
DIRF	Declaration of withholding tax	Annually	Last business day of February
PER/DCOMP	Federal tax set off and repayment request form	Daily	On the day of set off
SINTEGRA	Integrated information system for goods (ICMS)	Monthly	As set by state tax authorities
SISCOSERV	Integrated information system for services (ICMS) (new)	Monthly	As set by state tax authorities
DARF	Declaration of federal tax payment	Each payment	Deadline for the relevant tax payment
NF-e (e-Invoice)	Integrated electronic invoice format	N/A	N/A
e-lalur	Electronic taxable profits computation	Annually	Last business day of June of the following year
SEFIP/GFIP	Payroll information for social security taxes and charges (INSS AND FGTS)	Monthly	GFIP – by the 7th of the month following remuneration FGTS payment receipt – by the 7th of each month INSS payment receipt – by the 2nd of each month
GIA	ICMS return	Monthly	As set by each state
CAGED	Register of monthly employee changes	Monthly	7th of the following month

repayment from the government. Instead, these are generally carried forward and offset against future tax liabilities. On the plus side, overpayments or net credits of any type of federal tax can be offset against any other type of federal tax, although this is rarely possible for the different state taxes.

Conduct of enquiries

The conduct of tax enquiries differs from the UK. For example, meetings with the tax inspector are rare. Enquiries are often raised following the interrogation of electronic data by the tax inspector and are usually opened through the medium of a tax assessment rather than an enquiry letter. Although tax inspectors are beginning to demonstrate a more pragmatic approach to negotiation, it is still common that the taxpayer's only realistic option, where there is a difference in interpretation of the law, is to take the matter to the courts. As a result, there is a significant backlog of cases at every level of the judiciary in Brazil.

Electronic filing

Brazil was one of the first countries to implement electronic filing of tax invoices and tax returns, and most tax audits are conducted by electronic interrogation of taxpayer records. Brazil's sophistication in this regard often comes as a surprise to the foreign investor. It can perhaps be better understood when seen as a powerful tool that recent governments have employed in the fight against corruption.

All tax returns are filed electronically, using tax authority software, which enables the tax authorities to cross-check different tax returns for discrepancies in disclosure – for example, comparing salaries disclosed in the corporate income tax return and the social security return.

In addition, a new accounting system nomenclature for tax (SPED) has been introduced, such that the account descriptions in a company's trial balance are often dictated by the SPED requirements. SPED is an initiative to increase transparency between taxpayers and the tax authorities, aiming to consolidate

and integrate most tax filings under one system. The overall goal of SPED is to prevent tax evasion and unfair competition. Since 1 January 2008, Brazilian corporate taxpayers are required to file electronically every tax and accounting operation with the federal, state and municipal tax authorities. The SPED programme also requires every invoice that a company issues to be filed electronically with the tax authorities, with further integration programmes expected.

Interest and penalties

Interest charges are high in comparison to UK interest rates, but are set at relatively low levels in comparison to market Brazilian interest rates.

It should be noted that penalties are potentially due on both understatements of tax and underpayments of tax. Penalties on underpayments are set out in Table 2 below and are due not only in cases where fraud has occurred, but also on prompted disclosure on a tax audit. Penalties can also be due where adjustments are volunteered, even where the taxpayer was not negligent and may have obtained professional advice. Such penalties could be legally challenged, although doing so may be more costly than volunteering the penalty. Increasingly, state tax authorities may offer amnesties in this situation; federal amnesties are less common.

Table 2: The penalty regime

Late payment type	If paid within 30 days	Paid >30 days	Tax deductible?
Voluntary late payment	0.33% per day up to a maximum 20%	20%	Yes
Under-declaration on tax audit	37.5%	75%	No
Tax fraud	150%	150%	No

The penalty regime is rigorously enforced. In the past, it was usual for companies to be cautious and overpay taxes to minimise their exposure to penalties. However, that is becoming infrequent due to the less buoyant economy.

Setting up a business in Brazil

The bad news is that labour laws are complex and labour costs can be surprisingly high.

Types of entity

It is legally possible, but not commercially desirable, for non-residents to operate through a permanent establishment. Withholding and several indirect taxes would be applied to most amounts paid to the head office outside Brazil and would give rise to a higher tax burden than operating through a Brazilian company. It is legally possible for a foreign company to operate through a formal branch, but the formalities for setting up a branch are more stringent than for setting up a company and produce the same tax result.

Hence, the vast majority of groups establish a Brazilian company for their Brazilian operations, either a limited liability company ('Limitada' or LTDA) or a limited liability corporation ('Sociedade Anônima' or SA).

Unless there is a substantial tax advantage in the investor's home country, the disadvantages of a branch outweigh the benefits

Limitadas are the most common type of company. They are formed by two or more individuals or legal entities known as 'quotaholders' (equivalent to shareholders). A quotaholder may be resident or non-resident, with no minimum or maximum percentage interest. The limitada is the form that most closely resembles UK limited companies, with a level of flexibility (due to the quotas) that is usually only available to partnerships in the UK. Foreign quotaholders must have legal representatives in Brazil.

The liability of each quotaholder is limited to the total amount of their contribution, but all quotaholders are jointly and severally liable for the payment of the total paid-in capital. For the vast majority of limitadas, there are no minimum capital requirements.

In general, a limitada has fewer legal formalities than an SA and only large limitadas have to publish audited financial statements. Large for these purposes means companies with a turnover greater than R$300m (approximately £96m) or gross assets greater than R$240m (approximately £77m).

The SA is the form that most closely resembles UK PLCs. SAs can issue different classes of shares, such as voting and non-voting shares. Shareholder liability is limited to the amount subscribed. Foreign shareholders must have legal representatives in Brazil.

This type of entity is suitable for large businesses seeking to obtain funds from the general public. Like the limitada, the SA must have at least two shareholders which may be individuals and/or legal entities (resident or non-resident).

All SAs must publish their results, usually in official gazettes or major private newspapers.

Branches

A foreign company may operate as a branch in Brazil. However, unless there is a substantial tax advantage in the investor's home country, such as deduction for exchange losses against the taxable income of the head office, the disadvantages of a branch outweigh the benefits. It is difficult to establish a branch, which takes at least six months, and the establishment costs are nearly the same as for other business forms.

In order to set up a branch in Brazil a foreign company must submit an application to the Brazilian government, which must be approved by a Presidential Decree. A certificate of the Decree will be published in the Official Gazette, and a copy registered at the appropriate commercial registry. The branch can only start its activities when all the formalities have been completed. The foreign company must also empower a representative.

Labour costs

Labour laws are complex and labour costs can be surprisingly high. As well as employer taxes, the labour laws entitle employees to certain benefits that must be funded by the employer. The constitution sets overtime rates, provides for a monthly minimum

wage (salaries are expressed in monthly terms in Brazil) and regulates working hours. It lists a variety of labour entitlements, including maternity leave, holidays, workers' compensation, social services, medical assistance and unemployment benefits. All employees must hold work and social security papers in which the terms of their employment contracts must be recorded. Employers must maintain files containing detailed information about each employee and submit this information electronically to the labour authorities annually. The working week in Brazil is 44 hours over a six-day period (five eight-hour days and one four-hour day). The constitution guarantees employees many labour rights and benefits, which may increase a company's payroll costs by 70% to 80%. These include:

- approximately 30 days of paid holiday after one full year of employment. Employees are also granted a holiday bonus equivalent to a third of the monthly salary;
- a mandatory 'Christmas Bonus', calculated as the salary earned by the employee in December; and
- a deposit of 8% of salary to the severance indemnity fund (see below).

Employers must pay severance pay equivalent to the employee's salary for their notice period when dismissing employees without cause and without prior notice. For these purposes, the minimum prior notice period is deemed to be 30 days, plus three days for each year of employment, limited to 90 days.

If employees' rights and benefits are not observed, employees may sue their employer up to two years after termination of employment, and courts frequently favour employees. Labour claims may be filed in respect of the five-year period preceding the exercise of these rights. An employee is not permitted to waive rights or benefits stated in a law or in an employment contract.

Both employers and employees pay social security contributions. Individuals who receive employment income from a Brazilian source are subject to the local social security contribution, which is withheld by the employer. Contribution rates range from 8% to 11%, depending on the amount of the salary. There is a cap to the employee's contribution of 11% of the maximum income for contribution, resulting in a maximum R$457.49 (approximately £150) contribution.

The employer contribution ranges from 26.8% to 28.8% of each employee's monthly salary, depending on the employer's activity. There is no cap to the employer's contribution.

Employers are required to make contributions to the federal severance pay fund (FGTS) of 8% of an employee's monthly salary. Under certain circumstances, such as dismissal without cause, retirement, long-term sickness or, perhaps surprisingly, buying their first house, employees may withdraw these contributions from the fund.

Contributions are made as deposits in a restricted access bank account, in the name of each employee, and these accounts are managed by a federal government institution. If an employee is dismissed without cause, the employer must pay to the employee an additional fine, equal to 40% of the deposits made in the employee's FGTS account during the time of their employment with the company.

Exchange controls and taxes

The National Monetary Council sets Brazil's exchange controls. The central bank (BACEN), which is responsible for implementing this policy, has a number of departments which deal specifically with foreign investment and exchange. The foreign exchange market is controlled by the international capital and foreign exchange market regulation (RMCCI).

The registration process of foreign investments is relatively straightforward. The exchange contract must be made through a financial institution, normally a commercial bank, authorised by BACEN to operate in the foreign exchange markets. BACEN registers all investments into Brazil, whether in the form of capital or loans.

As a general rule, the RMCCI allows companies and individuals to purchase and sell foreign currency and perform international transfers in Brazilian Reais, regardless of the nature of the operation, with no restriction with respect to the amount involved.

In order to perform a transaction in the exchange market, BACEN only requires the parties involved to formalise it through an exchange contract and to register it in the Central Bank database system.

Profits that are reinvested in the business must also be registered as foreign registered capital, and the amount corresponding to the profits that can be remitted as dividends will be registered in local currency.

Some foreign currency transactions are subject to IOF tax. For example, equity is subject to IOF at 0.38% and short-term foreign currency loans of less than two years will be subject to 6% IOF tax, although these rates and definitions change regularly.

Corporate income taxes

As one might expect, companies are usually assessed on their actual profits, but it is also sometimes possible for companies to elect to be taxed under the simpler 'presumed profits' regime.

Tax rates

Corporation tax is levied at 34% of taxable profits, although this single rate is in fact the combination of two separate taxes, corporate income tax (IRPJ) and social contribution on profits (CSLL). There are some minor differences between their respective taxable bases; in particular, there are a few expenses that are deductible for IRPJ purposes but not for CSLL purposes. But, for all practical purposes, a single effective rate of 34% can be assumed. The rates are set out in more detail in Table 3 opposite.

Corporation tax: basic rules

The tax year is the calendar year, irrespective of the company's accounting period. Corporation tax returns are very detailed and must be submitted by 30 June of the year following the calendar tax year. Tax is paid monthly based on a monthly computation that forms part of the company's computerised records.

There is no system of group relief or tax consolidation. Mergers can generally be effected on a tax-free basis, provided that certain conditions are satisfied.

Brazilian companies are chargeable to Brazilian corporate income taxes on their worldwide profits, including the profits of their controlled foreign corporations (CFCs) and certain foreign affiliates (non-controlled subsidiaries), although this is subject to challenge in the courts. A very recent Supreme Court decision did not provide a definitive conclusion on this matter.

The definition of a CFC includes significant influence over corporate decision-making, a minimum 20% voting stock interest in the foreign company or being a member of the 'same economic group' as the foreign company.

Table 3: The rates of corporate income taxes

Tax	Rate	Calculation basis
Corporate income tax (IRPJ)	15%, plus a 10% surtax on annual taxable income exceeding R$240,000	Taxable income, being the accounting profit or loss before tax per the financial statements for the tax period (quarter or year), adjusted for add-backs and exclusions provided by the tax legislation, or presumed profit
Social contribution on profits (CSLL)	9%	Similar to the IRPJ's calculation basis

Companies are usually assessed on their taxable profits as computed by reference to book profits ('actual profits'), but it is also possible for companies that satisfy certain criteria to elect to be taxed under the simpler 'presumed profits' regime. In exceptional circumstances, the 'arbitrated profits' regime may be used.

Brazil has a multitude of indirect taxes

The actual profits regime is based on adjusted book profits and has many similar principles to other taxation systems, including exemption for dividends from domestic companies, tax deductible depreciation and requirements for expenditure to be necessary for the activities of the trade. There are also generous research and development and regional tax incentives; the former provides a 60% uplift on qualifying expenditure, the definition for which bears many similarities to the UK regime.

Tax losses can be carried forward indefinitely and utilised against future profit; however, the amounts offset are limited to 30% of taxable income in the year.

The presumed profit regime can apply if the company's total revenues were below R$48m (£15m) in the previous calendar year and it is not otherwise excluded (e.g. financial institutions). This limit will increase to R$72m (£23m) from 1 January 2014. The tax liability is calculated as a percentage of turnover rather than profit, which means that the tax return is much simpler to complete. The percentage varies depending on the activities of the company. For example, services are usually subject to a 32% rate, while goods are usually subject to an 8% rate for IRPJ and 12% for CSLL, an effective combined rate of just over 9%.

The arbitrated profit regime is rarely used and generally only applies where the company is unable to provide supporting information or the tax authorities suspect fraud. It is similar to the presumed profit regime but applies higher tax rates.

Indirect taxes

A tale of two VATs …

Brazil has a multitude of indirect taxes and, in view of the considerable indirect and withholding tax obligations, there is a strong incentive to source goods and services locally in Brazil wherever practicable and not to recharge expenses incurred abroad.

Indirect rates can vary from business to business and from state to state and care needs to be taken in order to minimise exposure to interest and penalties for incorrect filings and underpayments. Table 4 (overleaf) summarises the principal indirect taxes.

Federal VAT: IPI

IPI applies on industrialised products, generally those that have been through an industrial process as opposed to raw materials. It is a non-cumulative tax added to the invoice price at the time of sale. Each individual establishment offsets the total IPI paid on purchases (inputs) against the total IPI collected on its sales (outputs). IPI is thus ultimately borne by the final consumer. IPI is also levied on the importation of goods, in which case the IPI calculation basis would include the value of the goods, plus customs duties. Regarding imports, IPI rates may vary according to the nature of goods, from zero-rate for basic supplies and rising for non-essential goods, depending on the product's specific code in the harmonised tariff system.

The net amount of IPI due by the company must be calculated and paid on a monthly basis.

Certain products can be imported under special customs regimes which are exempt from IPI, if certain requirements are met. In addition, products or merchandise imported into free trade zones may be exempt and goods exported from Brazil are exempt from IPI.

State VAT: ICMS

The 1998 Constitution granted authority to the Brazilian States to collect the tax on the sale of goods, interstate and inter-municipal transportation services and communication services, even if the transaction and/or services rendered began in another country.

As with IPI, ICMS is not a cumulative tax. Each month, the supplier of goods or those services specified above calculates the amount of ICMS debits, generated on the sale of goods/services rendered, and ICMS credits, generated on the acquisition of goods/services received. If the supplier has more debits than credits, it will have to pay the difference to the state tax authorities. Surplus credits are usually carried forward to the following month.

The credits are computed at the time the merchandise enters the taxpayer's premises and the debits at the time the final products exit the establishment. Taxpayers are not allowed to claim credits on materials purchased that will be used on goods that will not be taxable when they exit the company, or are for consumption. Also, the ICMS credit related to the acquisition of goods registered as fixed assets must be spread over 48 monthly instalments.

ICMS is due on the value of the transaction or service carried out by the taxpayer, which includes the value of the tax itself (i.e. a gross-up calculation is required). For imports, ICMS is due on the value of the goods, plus customs duties, plus IPI, plus PIS/COFINS if applicable (see below) and the ICMS itself (gross-up method).

ICMS is collected by most states at the rate of 17%, except for the states of São Paulo and Minas Gerais, where the rate is

Table 4: The main indirect taxes

Federal	State	Municipal
II – Import Duty ■ Levied on import of goods (cost) ■ Rates: 0% to 35% Average: 14% **IPI – Federal VAT** ■ Levied on manufacturers' and importers' outputs and on imports ■ Rates: 0% to 330% Average: 14% ■ Imposed on importation **PIS/COFINS – social contributions** ■ Levied on gross revenues and importation of goods and services ■ Limited credit on inputs ■ Rates: ✓ Non-cumulative regime: 9.25% with credit on essential inputs ✓ Cumulative regime: 3.65% without credit on inputs ■ Imposed on importation	**ICMS – State VAT** ■ Levied on sales, transfers and importation of goods and on the supply of services of communication and interstate and inter-municipal transportation Rates: ■ Intrastate operations: 17% to 19%, depending on the state ■ Interstate operations: 12% (standard) or 7% ■ Tax benefits granted by certain states on importations and local outputs	**ISS – Tax on services** ■ Levied on supply of general services ■ Rates: 2% to 5%, depending on the nature of service and municipality involved ■ Cumulative tax (no credit on inputs) ■ Imposed on importation of services

Table 5: Interstate ICMS rates

From	To	Rate
South and Southeast region	South and Southeast region	12%
South and Southeast region	North, Northeast and Mid-West	7%
North, Northeast and Mid-West	Any other state	12%
Any state	Non-taxpayer	Internal rate from the state of the sender

18%, and Rio de Janeiro, where the rate is 19%. Special rates apply to interstate sales, as illustrated in Table 5 (above).

ICMS legislation provides for certain incentives and exemptions and each of the 26 states and one federal district ICMS tax authorities provides its own distinct benefits.

Service tax: ISS

Supplies of services, other than those subject to ICMS, are subject to a cumulative service tax (ISS) due on price of the service rendered. This is a municipal tax on certain services listed by the federal government.

In general, ISS is levied by the municipality in which the company is established. There are exceptions to this rule, such as the construction industry, dock services and towage vessel services, when the tax is levied by the municipality in which the work is performed and municipalities are also known to take a similar view in respect of other activities carried out in their jurisdiction.

The ISS rate varies between 2% and 5% from city to city and between services, with 5% being the most common.

ISS is charged on the invoice by the supplier and, as ISS is not creditable, it represents an additional cost for the recipient of the services. Where the service is provided to a Brazilian company by a supplier located outside Brazil, and either the service is performed in Brazil or the benefit of the service is realised in Brazil, then the Brazilian company must self-assess the ISS tax. Thus, in practice ISS applies to imports of services, including most intragroup recharges.

Social integration programme (PIS) and social contribution on revenues (COFINS)

The social integration programme (PIS) was conceived as a means for employees to share in profits through a mandatory national savings programme, financed by monthly deposits collected as a percentage of gross sales revenues. The social contribution on revenues (COFINS) was created to finance special federal social programmes by levying a percentage of gross sales revenues. They are subject to broadly similar rules and hence are commonly regarded as a single levy (PIS/COFINS).

PIS/COFINS can be either cumulative or non-cumulative (i.e. with input credits for the purchaser of the goods or services). The rules contain many anomalies which have been partially corrected over the years, but there are a great many disputes currently before the courts. It is expected that the rules will be simplified in the near future, but the current position is summarised below.

PIS/COFINS is charged on all revenues except for:

- items that are specified in the law or by decree as either tax-exempt or taxed at a rate of 0%;
- cancelled sales and unconditional discounts;
- accounting adjustments, such as reversal of provisions, recovery of costs and expenses;
- equity dividends;
- proceeds from the sale of permanent assets; and
- revenues already taxed, due to the application of a tax substitution system.

Exports of goods are exempt from PIS/COFINS, as are services rendered to overseas companies, if the respective payment entails inflow of foreign currency into Brazil.

Companies are also required to self-assess PIS-importation and COFINS-importation on importation of goods and services which would be revenue as set out above. If the non-cumulative regime applies, a credit may then be available if the expenditure qualifies.

Under the non-cumulative regime, the rates of PIS and COFINS are 1.65% and 7.6% respectively. The recipient of the goods or services can claim PIS/COFINS credits to offset amounts due on their own sales at the same rates. Credits can be claimed on amounts related to:

- goods acquired for resale;
- goods and services used as inputs in performing services and producing other goods for sale;
- payments to third parties for rentals of buildings, machinery and equipment;
- expenses related to commercial leasing transactions;
- depreciation of machinery, equipment and other assets;
- depreciation of freehold or leasehold buildings and improvements used in the company's activities;
- goods that have been returned;
- storage of goods and freight due to sales transactions, when the cost is borne by the seller; and
- electricity and thermal energy consumed in company establishments.

However, credits cannot be claimed on:

- salaries paid to individuals; and
- goods and services not subject to PIS/COFINS because they are exempt or subject to PIS/COFINS at 0%.

Rights to PIS/COFINS credits generally apply only to goods and services acquired from, or costs and expenses incurred, paid or credited to, companies established in Brazil. However, credits from imported goods and services are allowed, provided they are subject to PIS-importation and COFINS-importation.

It is a matter for the providers of goods or services to decide whether or not the law requires them to add PIS/COFINS to the invoiced price. The amount is not necessarily identified on the invoice, so it may not always be clear to the purchaser whether they are entitled to a credit in filing their own PIS/COFINS returns, which can create uncertainty over the purchaser's own PIS/COFINS compliance position.

PIS/COFINS is due on a monthly basis and credits not used in one month may be carried forward to the following month. The exemption granted to export transactions does not prevent PIS/COFINS credits from being claimed on inputs. Indeed, as PIS/COFINS is a federal tax, export companies can utilise PIS/COFINS credits associated with export transactions to offset against future liabilities of PIS/COFINS or any other federal taxes.

Under the cumulative regime, the rates of PIS and COFINS are 0.65% and 3% respectively, but no credits are available to offset amounts due on their own sales. The cumulative regime is simpler to operate, but usually results in a higher tax burden for corporate taxpayers in the supply chain. However, companies using the presumed profit regime *must* use the cumulative regime for PIS/COFINS.

Cross-border matters

Examining export credits, import duties, withholding taxes, transfer pricing rules and tax treaties.

Export credits

Revenues from exports are exempt from PIS/COFINS, and exporting companies can use PIS/COFINS credits from inputs associated with export transactions to offset against their monthly PIS/COFINS liabilities or any other federal taxes.

Goods exported from Brazil are exempt from IPI and exporting companies can use the credits on inputs. If the exporting company is unable to offset IPI credits for a three month period, it is entitled to offset the accumulated credit against any other federal taxes.

Export transactions are also exempt from ICMS, but carried-forward credits from exports can only be used to offset against future liabilities of ICMS itself.

Importation of goods

The importation of goods into Brazil attracts import duty and PIS/COFINS and, if applicable to the goods in question, ICMS and IPI. Import duty rates are included in Table 4.

All Brazilian goods importers and exporters are required to have a trading licence (RADAR), which grants a password to access the Brazilian Integrated Foreign Trade System ('Sistema Integrado de Comércio Exterior', known as SISCOMEX).

SISCOMEX is an electronic integrated trade documentation system designed by the government to control and monitor Brazilian foreign trade. SISCOMEX is supervised by the Chamber of Foreign Trade, the Federal Tax Authorities and the Central Bank.

There are three types of RADAR licences: express, limited and unlimited. The requirements to qualify for each type can be checked directly at SISCOMEX, by inputting the harmonised tax system code for that product.

In addition to import duty and the indirect taxes mentioned above (IPI, PIS/COFINS and ICMS), imported goods are subject to other charges, such as: the AFRMM, levied on all imports transported via maritime freight; warehousing; and the Capatazia foremanship fee, charged for moving products within port areas.

Importation of services

The definition of services for Brazilian indirect tax importation and withholding tax purposes is much broader than in many other countries. As well as the ordinary definition of services, royalties are treated as services for Brazilian tax purposes, and recharges or cost-sharing of management services are also characterised as the importation of a service. Accordingly, in practice, almost any payment in respect of an item which is not a physical good, capital, loan principal, dividend or interest will be the import of a service.

As described earlier, imported services are subject to PIS/COFINS and ISS if the service is performed in Brazil or if the benefit of the service is received in Brazil. The calculation basis of the PIS/COFINS-importation comprises the amount paid, credited, delivered, utilised or remitted abroad (before the withholding tax deduction – see below), plus ISS and the contributions (PIS/COFINS Importation) themselves (i.e. gross-up method).

Services are only deductible expenses of Brazilian companies if they are necessarily incurred for that company's business. However, in practice the Brazilian tax authorities view intercompany recharges sceptically and will often require evidence of the economic benefit gained by the Brazilian entity from the 'services' received. In particular, they are unlikely

to allow deductions for group recharges and, in practice, it is generally better not to recharge such costs to Brazil as the indirect taxes will still be chargeable even if the expense is disallowed for corporate income tax purposes. Under the Actual Profits regime, the tax deductibility of royalty payments is generally allowed but limited, depending on the industry, to up to 5% of net revenues.

The Brazilian transfer pricing rules deviate substantially from the OECD guidelines

As from late 2012, the importation of services is now required to be registered on SISCOSERV, the services equivalent of SISCOMEX. In addition to PIS/COFINS and ISS, imported services are subject to withholding tax and in certain instances the 'contribution for intervention in the economic domain'. These are discussed below.

Withholding taxes (IRRF)

On applying to remit any funds overseas at a company's bank, the company is required to identify what the remittance relates to, to confirm that the correct withholding tax has been withheld and, sometimes, to provide evidence of payment of withholding tax.

Any payment, credit or remittance made by a company located in Brazil in respect of a service, royalty or interest to an individual or legal entity residing or domiciled abroad is subject to withholding income tax (IRRF). The usual rate is 15%, although payments made to tax haven jurisdictions are subject to a 25% withholding tax rate.

Contribution for intervention in the economic domain (CIDE)

CIDE is levied at the rate of 10% on amounts paid, credited, turned over, employed or remitted each month to parties resident or domiciled abroad, in respect of licences or contracts relating to a transfer of technology or contracts providing technical and administrative assistance.

CIDE is not a withholding tax, as the payer is the party primarily liable to CIDE and does not withhold it from the payment received by the payee.

Withholding tax on sale of Brazilian companies

There can also be a withholding tax on a capital gain realised by a non-resident on the sale of shares in a Brazilian company. The gain would be measured as the difference between the consideration received and the tax basis registered with BACEN at the time of the original acquisition. The tax would be 15% of the gain. None of Brazil's tax treaties grant relief from this withholding tax.

If the capital gain is derived by a tax haven resident, the rate is increased to 25%. According to domestic law, the purchaser is responsible for withholding and paying the tax to the Brazilian tax authorities if they are Brazilian resident, while the legal representative in Brazil of the non-resident buyer is liable if they are non-resident.

It is possible to transfer companies within a group at cost and, therefore, without generating a gain or crystallising a withholding tax charge.

Transfer pricing

Brazil's transfer pricing regime includes provisions aimed at preventing Brazilian subsidiaries of multinational companies from diverting profits abroad by overcharging intercompany exports or reducing taxable income in Brazil by undercharging intercompany exports. The rules apply to cross-border transactions between related parties, with certain uncontrolled agents, distributors or consortium partners, or with entities located in tax havens or in a jurisdiction that allows secrecy regarding equity participations.

The Brazilian rules deviate substantially from the OECD transfer pricing guidelines. They do not adopt the arm's length principle, but use safe harbours and fixed margins to calculate the transfer price.

The salient features of the Brazilian transfer pricing regime are as follows:

- exclusive use of transactional methods – comparable uncontrolled price, resale price and cost plus – for determining the price of uncontrolled transactions in property, services and commercial rights;
- statutory fixed margins must be applied through the prescribed methods, unless a different margin is established by data from official publications or research conducted by a technically qualified firm;
- export safe harbour rules are available to avoid application of the prescribed transactional methods; and
- specified interest rates for controlled cross-border loans.

In September 2012, the government amended the transfer pricing rules applicable to the importation of goods, services and rights, set new profit margins for certain sectors, and created two new transfer pricing methods. Although the new law applies to fiscal years starting on or after 1 January 2013, taxpayers may opt to apply the rules from fiscal year 2012.

The law introduced two additional transfer pricing methods to the existing Brazilian methods: the commodity exchange import price, and the commodity exchange export price, for inbound and outbound transactions with commodities, respectively. Under these methods, the basis for comparison is the average commodity exchange price for the relevant items, adjusted for upward or downward spreads.

For commodity products not negotiated in commodity exchanges, the amended law also allowed the use of prices obtained from reputable market institutions. The tax authorities provide a non-exhaustive list containing 21 classes of products that the Brazilian tax authorities consider commodity products. These include cotton, meat, soy, orange juice, petroleum, gold, iron and steel.

Additionally, the new rules specify the institutions the Brazilian tax authorities consider reputable and that can be used as source for obtaining commodity product prices.

Interpretation of tax treaties

Brazil has signed a total of 29 treaties that are currently in force, most of which follow the OECD model treaty, although there are notably no treaties with the UK or the US and none expected. Brazil is implementing the OECD initiative on exchange of information, either by signing new treaties or agreeing protocols to existing tax treaties. Most of the treaties signed have exchange of information provisions. The treaties generally provide for relief from double taxation on all types of income, limit the taxation by one country of companies resident in the other, and protect companies resident in one country from discriminatory taxation in the other. However, it is often difficult to obtain tax

authority agreement that treaty relief is available, particularly in the case of IRRF. It is not possible to take a position on a tax treaty without federal tax authority approval, as Brazilian banks will not permit the transfer of funds without it. Therefore, the absence of a UK treaty does not, in practice, disadvantage UK groups.

A foreign tax credit may be claimed for foreign tax paid, limited to the corporate income tax liability on taxable foreign-source income. Withholding taxes are creditable, as well as underlying income tax paid if certain conditions are met, even if there is no double tax treaty.

Brazilian investments

How to structure and finance a Brazilian investment.

Structure

Brazilian vendors tend to prefer to sell shares rather than assets. Hence, acquisitions are likely to be structured as share acquisitions rather than asset deals. If debt finance is to be introduced via a Brazilian acquisition vehicle (see also debt financing below), it is necessary to merge the acquisition vehicle with the Brazilian target, as there is no tax grouping in Brazil. Tax-free mergers are possible and indeed quite common, in order that interest on acquisition debt and interest on net equity (discussed below) can be offset against the target's profits.

In addition, it is possible to obtain a tax deduction in respect of goodwill amortisation, although not for any other intangibles, in the merged company. The amount of goodwill must be supported by an independent valuation report which, inter alia, will support the economic substance underpinning the valuation and determine the range of periods over which the taxpayer can choose to deduct the amortisation (minimum five, maximum 20 years).

The tax authorities have, so far with limited success, challenged the deductibility of goodwill amortisation in the courts on several occasions, generally on the basis that they consider the merger to be designed to obtain a tax deduction. It must be noted, however, that draft legislation provides that, for acquisitions made on or after 1 January 2014, goodwill amortisation deductions remain available but are deferred for five years.

Debt financing

Historically, debt financing was relatively straightforward: provided an intra group loan was registered with BACEN, the interest was generally deductible, although interest paid to an entity not resident in Brazil was, and remains, subject to withholding tax (IRRF) at 15%.

Thin capitalisation rules were introduced in 2010, under which interest paid to related parties can only be deducted if the interest expense is necessary for the company's activities and both of the following thresholds are met:

- the related party debt-to-equity ratio does not exceed 2:1, based on the proportion of related party debt to direct equity investment made by related parties; and
- the overall debt-to-equity ratio does not exceed 2:1, based on the proportion of total debt to total direct equity investment made by related parties.

For interest paid to an entity or individual located in a tax haven or that benefits from a preferential tax regime, regardless of whether the parties are related, the above debt-to-equity ratio is reduced to 0.3:1.

Any excess interest will be treated as a non-deductible expense for IRPJ and CSLL purposes. There is no re-characterisation of the disallowed interest, meaning that interest is taxable and continues to be subject to withholding tax.

However, the recent changes to the transfer pricing rules introduced a new restriction on interest paid to overseas connected parties for new loans, or amended existing loans, taken out on or after 1 January 2013. Originally, the proposal was to limit the deductible interest expense to US$ LIBOR plus 3%, even if the loan was designated in R$ and regardless of the company's thin capitalisation position. However, at the last moment, the specified interest margin was withdrawn and for variable rate loans in foreign currency the base rate is restricted to 6 month LIBOR for the currency of the loan, but the margin is to be determined by the tax authorities on a case by case basis. For variable rate Reais loans, both the base rate and the margin are to be determined by the tax authorities on a case-by-case basis.

Understandably, this has caused great uncertainty. In practice, it is understood that many companies are now structuring their debt in line with the limits originally announced (US$ LIBOR plus 3%). Alternatively, companies are choosing to inject more equity, instead of debt finance, and claim a higher 'interest on net equity' deduction, as this is not subject to these new limitations.

Interest on net equity (INE)

Normal dividends are not tax deductible and do not attract any withholding tax. But Brazil also provides for a tax deduction based on a company's equity – INE. This is effectively a tax-deductible dividend.

INE is calculated by applying the long-term interest rate, as determined by BACEN, to the company's equity. The amount of deductible INE is limited to the greater of 50% of the current year profit before tax or 50% of accumulated brought forward earnings. It is deductible without regard to the thin capitalisation position of the company or the new transfer pricing restriction that applies to interest. INE is subject to 15% withholding tax (WHT), in the same way as normal interest.

INE is generated by the making of an election, similar to a dividend declaration, and indeed generally accounted for as a dividend. It is deductible for Brazilian corporate income tax purposes when the WHT is paid, and the INE itself need never be actually paid.

The INE is most efficient when the immediate shareholder is a company located in a jurisdiction that does not tax the INE as income (e.g. The Netherlands). Here, there will be a 19% reduction in the overall tax burden, since the expense will reduce Brazilian corporate income tax at 34%, but the WHT will not normally be recoverable by the recipient company.

This benefit would be eroded, however, if the ultimate parent is subject to the UK CFC rules. Under UK rules, although an ordinary dividend would be tax free, INE is considered to be taxable in the hands of the recipient, as it is akin to a tax-deductible dividend, so the UK parent would be subject to UK CFC tax, with credit for withholding tax, on any INE received by its foreign sub-holding company.

For the first report in the tax and BRICs series, on China, see *Tax Journal*, dated 5 July. Reports on India and Russia will be published in the coming months.